the, the CLEC is allowed to charge access prices that are higher than the, than the ILEC, and if, and if the CLEC passes through, if you like, some of those -- some of that revenue to their local exchange customers, then, then you will get some pass through to customers.

The problem basically is that what you're setting up is a situation which in many ways is reminiscent of the pre-MFJ world in which what you're saying is we're going to take a CLEC and we're going to allow them to tax somebody else, long-distance customers of other LECs, and use that money, maybe some of it, how much of if w don't know, to basically subsidize entry.

What we've sort of learned out of, you know, a long history of telecommunications here is this kind of cross-subsidization where you tax long distance in order to subsidize local exchange is really very inefficient. Economists object to it because demand for long distance is relatively elastic, and so it's a very inefficient tax.

There are a number of other reasons why you would object to it. There's no guarantee that the CLEC in fact will indeed pass on much or all of that tax revenue to, to its own customers of local exchange in the form of lower prices for local exchange.

Some of it may simply be retained by the CLEC. Just because you're, you're given the right to tax doesn't mean that you pass it on. Also, of course, what this creates is the potential for inefficient entry so that, you know, must of that tax revenue will simply be dissipated in the form of high cost and inefficient entry, and that's the sort of thing that, that nobody really gains from.

So, you know, I think that just as a general policy matter, however keen one may be on entry, including entry into markets where there's an incumbent monopolist, what you really want to do is you want to give entrants shall we say the pricing signal so you get the right amount of entry.

MR. MERON: Thank you. That concludes my questions.

JUDGE CHACHKIN: Cross-examination?

CROSS-EXAMINATION

BY MR. CANIS:

Q Thank you, Your Honor. Hi, Dr. Warren- Bouton. My name is John Canis and I'm here for MGC. Did I hear you correctly state that a smaller LEC has a greater incentive to increase originating access charges than a large LEC?

A I'm saying that the smaller the LEC, the less the disincentive against raising a price because of the responsiveness of customers. LEC may face particular reasons for why other effects than that may constrain it or other things.

What I'm talking about here is the

normal response of customers to when you raise prices, and what I'm saying is that the smaller the CLEC under the conditions under which the IXC has to pass it on, the less the repercussions of their own actions in terms of the demand that they see.

Q So, you're talking about market forces from end user customers?

A Yes.

Q I'm not talking about small CLECs now. I'm talking about large ILECs. Let's say SBC and Bell Atlantic. Is it AT&T's position that market forces are adequate to drive the originating access charges of SBC and Bell Atlantic down to reasonable cost-based levels?

A I don't know what AT&T's position would be. I could tell you what my position would be.

I think I would, I would come back to the same thing which is I don't think that originating access -- that market forces by themselves are likely to produce a purely competitive outcome with respect to originating access.

Q Do you know AT&T's position concerning the originating access charges that SBC and Bell Atlantic charge?

A No.

Q So, you don't know that AT&T, whether economist believes those to be reasonable or grossly inflated?

A Well, it's my understanding that the originating access fees that are charged by the ILECs, even the large ones, are considerably above the ILEC's marginal cost of providing originating access, always have been. But the, the levels that we're talking about are, are simply very much smaller.

The level of originating access charged by the IXCs -- I'm sorry, by the ILECs with whom for example MGC competes are, are tiny compared to the originating access charge that, that MGC is trying to impose.

Q Do you know what a typical, and again, I'm talking about big ILECs like SBC or Bell Atlantic, do you know what a typical originating access charge is for those carriers?

A I couldn't tell you exactly. The -- it's -- I think I read through the pleadings, and one-half of one cent would be my recollection.

Q That's on a per-minute charge. Right?

A Yes.

Q Does that factor in any PICC charges?

A Well, I read AT&T's statement, your counterresponse, that said that it didn't -- in any PICC charges. AT&T's response said that it did, you know. I don't know. It depends I guess which side of the courtroom one believes.

Q Let me ask you this then. If you wanted to include the total of effect of

PICC's residual, or rather residual interconnection charge, residual carrier common line charge, plus originating access, do you know what the equivalent per-minute rate would be for SBC for Bell Atlantic?

A I can't tell you the exact number. It is my understanding though that the rate for SBC or Bell Atlantic is a fraction of the MGC rate pretty well no matter what you put in there.

Q That's not what I asked you. Do you know what the equivalent rate would be for SBC or Bell Atlantic?

A Oh, no. I can't tell you what the rate is. What I -- all I can tell you is that it's, it's far lower than the SBC rate.

Q Would it be several cents?

A I think I've just testified that I can't tell you what the exact number is. My only point, and all that's relevant to my analysis is, that it appears to be far lower than the MGC rate.

Q Mr. LaMontagne stated that it was AT&T's position that a reasonable access charge that should be paid by a big ILEC should be about a quarter two a third of a cent.

A I haven't read the deposition, but I find that to be a perfectly reasonable statement. The reason is, of course, because my understanding is that exceeds the marginal cost of providing access. The comments are very keen on marginal cost pricing, and I think it is sufficient.

Q Are you familiar with the term "average schedule companies"?

A No.

Q Let me ask you this. Are you aware of the term tier one ILECs?

A I certainly was at some point, yes.

Q Do you want to say that currently tier one ILECs would include RBOCs, GTE, and a couple of other of the largest ILECs with annual regulated revenues in excess of 100 million?

A I'll certainly accept that.

Q Are you aware of the other LECs?

A There are lots of LECs.

Q Lots of them, right? Are you aware of any ILECs that price their own originating access out of the NECA tariff?

A That price their own? Do you want to define what you mean by price their own originating access? In other words, to their own -- you are talking about LECs which are integrated into long distance?

Q No. Are you aware of any incumbent LECs that are not tier LECs that concur in the NECA tariff and charge NECA access rates?

A It is my understanding that there are LECs that charge the NECA tariff, yes.

Q Do you know what the NECA tariff rates are for originating access?

A I think that MGC is using the NECA tariffs. That is my recollection.

Q That wasn't my question. My

question is do you know what the rates are in the NECA tariff.

A Well, I have read them.

Q Can you tell me what those rates are?

A Not exactly. My impression was it was about five and a half cents.

Q It is your understanding that MGC mirrors those NECA rates?

A That is what I understand that you stated, yes.

Q Just for the sake of this discussion, let's assume that the small independent ILECs that concur in the NECA tariff are called average schedule companies. I'll just use that term.

A Okay.

Q Would you consider these average schedule companies to be tiny LECs?

A Well, it is my understanding that most of those would be relatively small, rural LECs, high cost, out in the country. I don't think they are very similar to MGC, but --

Q According to your definition of tiny LECs, would these tiny, average schedule ILECs have the same incentive to increase their access rates and have a greater incentive to increase their originating access rates than large ILECs?

A Well, I think as I have sort of said here, that in terms of the incentive, shall we say, to restrain pricing in terms of the effects that it has on your customers, the smaller the share of the IXC's customers that you account for, the less the restraining effect of normal market forces.

Q Does that mean your answer to my question is yes?

A No. The answer to the question is there may be several reasons why -- different reasons why different LECs choose to try to have certain originating access prices. What I am looking at is the question to which market forces are attenuated because of the particular market failure here.

I'm not making a statement about individual LECs. I'm saying that there is an attenuation of market restraints on a LEC when it is a small percentage, when it accounts for a small percentage of the IXC's customers.

Q I'm talking about any specific LECs either. I think I started out this line of questioning asking you if it was your position that smaller LECs have a greater incentive to increase their originating access rates than do bigger LECs. Is that the case?

A All else being equal, yeah.

Q All right. Does that apply to small incumbent LECs as well as CLECs?

A If they are in the same situation.

Q Do you know whether AT&T is refusing to pay the access charges of these small average schedule ILECs?

A On the NECA tariff?
Q Yes.
A I don't know, but I don't think they are refusing. It is also my understanding that those ILECs are generally speaking high cost, rural, local exchange companies, and that we are not faced with a situation in which the customer can -- enough.
Q Have you conducted a study of MGC's cost?
A Of GTE's cost?
Q MGC's cost.
A Oh, MGC's cost. No. I think what I have just said to you is it is my understanding that MGC is not the kind of rural, high cost, long distance, routine subscriber carriers that is characterized by the NECA tariff.
Q On what do you base that assumption?
A My counsel informed me of that.

Q All right.

A Since I asked him.

Q So that statement that you just made is not based on your personal knowledge of economic reality, any evaluation of cost data, or any knowledge of MGC as a particular carrier. You just said that based on what your counsel told you to say. Is that the case?

A Well, MGC is in Atlanta, Las Vegas, and Ontario. The last time I was in all three of those towns, they didn't look much like West Virginia.

Q Let me repeat my question. Is your statement concerning your assumptions regarding the cost of MGC, and that MGC's costs are not similar to the costs of NECA carriers, is that based on any cost studies that you have conducted and any first hand knowledge that you have of MGC's costs?

A I think I could repeat the statement that it is my understanding that

NECA tariffs and NECA -- are imposed mainly by rural carriers.

It is my understanding of the location of your sites that they are Atlanta, Las Vegas, and Ontario. From my personal observation of those three cities, they don't look very rural to me.

Q Now I am going to?

A Whether you want to call that a cost study or just a sort of a casual observation is fine.

Q I am going to ask this question one more time, and I am going to ask the administrative law judge to instruct you to answer my question with a yes or no, and then you can elaborate as you wish.

Your statement that you just made that you don't believe MGC's costs are similar to the costs of a NECA carrier, is that determination based on any expressed cost study that you have done of MGC's rates and MGC's costs, and any personal knowledge that you have of what MGC's actual costs are.

A I would repeat that, which is that no, except insofar, of course, that MGC is not located -- MGC customers are not located in rural areas.

Q Did you advise AT&T that it should not pay any class of carriers originating access charges?

A No. It is irrelevant to what I do.

Q Did your analysis factor in, to your knowledge, to Mr. LaMontagne's decision to withhold originating access charges, payment of originating access charges to MGC?

A I have absolutely no idea. I think that is an appropriate question for somebody else. I'd love to believe that I influenced large businesses, but I am afraid I probably don't.

Q Do you know how much originating access AT&T pays to tier one LECs?

A I think you have already asked me that question.

Q I don't think I have. Would you care to answer that?

A I think my answer was I can't tell you exactly how much it was, but it was a very small fraction of what MGC is paying.

Q No, no, no.

A I was estimating it at about one-half of one cent.

Q I'm sorry. That's not my question. Do you know in total the dollar amount on an annual basis that AT&T pays to tier one LECs for originating access?

A No.

Q Do you know the amount that AT&T pays to average schedule companies for originating access?

A Do I know the amount? No. The exact amount?

Q Do you know the amount that AT&T pays to CLECs for originating access?

A Obviously not.

Q If you had to guess, what would you

guess as to the relevant dollar amounts that AT&T pays to those three classes of customers.

MR. MERON: I object.

THE WITNESS: This is a meaningless question.

MR. MERON: I don't know what relevance a guess would have to this case.

JUDGE CHACHKIN: Sustained.

BY MR. CANIS:

Q Do you believe that there is an economic rationale from an economist's perspective for AT&T's refusal to pay access charges charged by CLECs, but not to refuse to pay access charges imposed by ILECs, whether tier one or average schedule?

A You are either going to have to repeat the question, or let me paraphrase it.

Q Is there any economic reason that you can think of as an economist why AT&T would refuse to pay the access charges imposed by CLECs, but would not refuse to pay the access charges imposed by tier one LECs or average schedule ILECs?

A As a general statement, I guess the question seems to me to be meaningless.

I want to put some structure on it by saying the price charged by a CLEC or by the ILEC with whom that CLEC was competing, that might be a relevant apples to apples origin. But otherwise, you have got a question which just does not make a great deal of sense to me. But I can try answering my question. But, of course, it is my question and not your question.

Q That's fine. Did your analysis have input into the economic arguments in AT&T's answer and statement of facts and conclusions of law?

A I don't know. Again, one would hope so. But I'm -- you know.

Q Are you aware of an argument by AT&T that the cost that MGC has to pay for an unbundled loop exceeds the rates that it charges for local service, it must be subsidizing its loop expenditures by revenues generated from an IXC?

A I have read the section of AT&T's response that refers to that. I'm not sure they describe it exactly that way, but more or less, yes.

Q If I was inaccurate, could you phrase that in the way that you feel comfortable phrasing it?

A I think AT&T is saying that observing prices that you are charging for local exchange which exceed even your marginal cost of providing local exchange implies that you are presumably being cross-subsidized from some other source. Of course, the likely source is originating access fees.

Q That was AT&T's argument, though? That argument was crafted by AT&T without input from you, its economic witness?

A I don't think that is an economic

argument. That's an inference. I think it is a factual inference.

Q I would assume that the allegation of cross-subsidization is an economic argument. If you can just answer my question.

A The question was?

Q Did you have any input into that argument that appears in the AT&T brief?

A No. That is not to say that some other economist didn't. But this economist didn't. AT&T has a lot of economists.

Q So if I were to ask you then whether in making that argument AT&T considered whether MGC recovers revenues from other sources like its own long distance service, like its vertical features and functions, and from other revenue streams for services such as Internet access that it provides over that same loop, you would have no knowledge as to whether AT&T considered those factors when it made those arguments?

A I can't tell you what AT&T or whoever wrote that was thinking at the time that he wrote it.

He is simply making a comparison between what appears to be your major source of revenue and what appears to be your major cost, and just pointing out that that major cost component, which is the cost of running the local loop, seems to exceed the direct revenues that you are getting for local exchange service.

Q You don't know whether AT&T was thinking that. That is your assumption.

A Well, it is hard for me to know what AT&T is thinking, either individually or -- I think your -- it is probably a question you might want to ask somebody else.

MR. CANIS: That's fine. I have no further questions. Thank you.

JUDGE CHACHKIN: Does FCC counsel have any questions?

MR. LAMANCUSA: None.

MR. REYNOLDS: Actually, I actually do.

BY MR. REYNOLDS:

Q One area that we haven't discussed much is that what I consider a somewhat atypical vertical relationship in this case, in that the end user is really a customer of both the LEC and of the IXC. The actions of one, either the LEC or the IXC, can potentially impact the end user's impression or what have you of its relationship with the other.

Is that something we should be considering in evaluating where various responsibilities should lie, and in particular with respect, one of the things I am particularly concerned about is whether the end user in these types of cases is going to be able to have sufficient information about what is going on, why it creates -- for instance, it is not able to access either AT&T or long distance carriers. It is always whose responsibility that is.

So my question to you is that something we should consider, and if so, how does it influence our consideration?

A Well, I think it is important as a general matter that consumers be given as much information as possible.

This is not an area in which -- well, I think that, for example, if a CLEC calls a customer of the local ILEC and says I'd like to offer you, you know, less expensive, better, fancier local exchange service, then that CLEC also has a duty to inform the customer as to the impact of that decision, you know, in other areas.

For example, if the effect is going to be, well, unfortunately, you can't use AT&T, all you can use is MCI and Spring, no. You should let the customer know that.

Similarly, I think that it is important for, say, an AT&T customer who would like to be an AT&T customer to be told that, nope, he can't be an AT&T customer because he has chosen that particular CLEC, so that I think what is important is the customer know what the impact of his decisions is, and the more of that kind of information in general the better.

I don't think you want to have a confused situation in which one side, you know, can blame the other for what is going on. We don't want a situation in which, for example, the customer is simply cut off, and he thinks -- an example back here was because he didn't pay the bill or something like that.

Q You seem to place that responsibility on the CLEC in this instance. Why are you inclined to find that responsibility to that site?

A Well, I think you want to place that responsibility in the hands of whoever is initiating the decision.

In other words -- and I understand

from the prior testimony that at the time, for example, that MGC or another CLEC contacts a customer, is actively marketing a customer, that it is possible to tell that customer at that point what is going on.

I think it would be much more difficult -- I'm not quite sure how it would work if the customer had to be -- all of AT&T's customers had to be told what would happen if they switched to MGC. I mean, that is a very expensive operation to do for a very small pull. I'm not sure if that is quite getting at your answer.

But, you know, it would be similarly as, for example, terminating access. If there was a fight over terminating access, and for whatever reason an IXC decided that they didn't want to use a CLEC for terminating access, you know, I would expect it to inform its long distance customers that, you know, the reason why you can't get a hold of your Aunt Millie in Las

Vegas is because, you know, Aunt Millie is using MGC, and maybe what you should do is call 10-10-MCI.

So in general, I think that whoever is initiating the transaction publicly has some kind of duty to inform the customer of the impact of that decision.

Q Do you agree that MGC or a CLEC's inability to offer to their end users a broad selection or sort of the broadest selection of choice in IXC could affect that end user's decision to go with a competitive local company?

A I certainly hope so. You know, increasingly, long distance service is just becoming a commodity. I know that people think the IXC is like AT&T. The -- are not the case. But for most of us, you know, a long distance call is a long distance call is a long distance call.

Now I think there are still some customers out there who truly value a particular -- who have a brand differentiation, either who particularly value the particular service that a particular IXC like AT&T may offer, or may particularly value the brand.

My mother, for example, you know, never forgave me for being part of the breakup. She was an AT&T person until the day she died, and she couldn't understand why I thought competition was such a great thing.

It just confused the heck out of her. So it is perfectly true that if MGC had called up my mother and said, hi, we would like you to switch to -- away from the local Bell company to our company, and by the way, you can't get AT&T, my mother would have hung up.

But there aren't too many, you know, little old ladies left like that around there. The real issue is if there are some, what it means is that there is some brand differentiation.

Then it means essentially in this situation at least some of the demanders have some kind of bargaining power. So, for example, it could well be the case that MGC had customers who particularly wanted to have AT&T, then what they might do is they might be willing to, you know, agree on a price that is somewhere less than 4.9 cents.

I can get MCI for 4.9 cents because nobody cares about MCI. But since some of my customers really care about AT&T, I'll cut a deal with just 4 cents for AT&T. I think that in this context -- you have to understand the way I am coming at this.

You know, from my point of view, the more of that the better because we are sitting up here at prices which greatly marginal cost. Any product differentiation that is out there that could reduce this number from my point of view is probably a good thing.

The real issue is whether or not

there exists an IXC who is so critical to a sufficient number of customers that the fact that MGC can't market to my mother any more really constrains their growth.

So, I mean, if there is this pool of customers that are out there, the question you have to ask yourself is there is a little group of them which basically will never switch. These are, you know, AT&T diehard loyalists, and here are MCI diehard loyalists, and things like that. We look at MGC, which is here.

The question is is their growth really constrained by the fact that they can't access AT&T customers or MCI customers. It is my understanding that the answer to that is no, that we are very, very far away from any concern like this that an IXC might, through its brand differentiation, might have put too much countervailing power or bargaining power or vis-à-vis the CLEC.

BY MR. LAMANCUSA:

Q Doctor, are those the only factors that you would consider that we just mentioned that would create a downward pressure on the reservation of prices? In other words, right now you have the price reaching 4.9, and then you have identified some factors which may in a sense shift that to a lower value.

These diehard AT&T or MCI customers. What other factors would you use or analyze in trying to determine whether there was any relative market strength by a particular IXC which could drive the price even below the level of the monopolist ILEC?

A Well, the obvious one for the economists is actual re-entry and choice with the CLEC. I mean, if AT&T, for example, in this situation decided to vertically integrate and actually provide -- do it itself -- that is always one solution to being monopolized, is just make it yourself.

In principle, I suppose if AT&T

felt that the price was getting too high, and if it was willing to incur the costs of actually going out and building another, you know, going into the home and providing local exchange service, they could simply say, well, listen, we can do it ourselves, and we can do it for four-tenths of one cent.

So if we can get the customer -- but you are still back in the situation in which whoever has got the customer here, sort of, you know, controls the originating access decision. But in terms of bargaining power of coming back in again, you know, vertical integration is always one possibility. But it may be, for all intents and purposes, pretty far down the horizon. It doesn't seem so far to really have constrained the pricing.

Q No other factors that you can think of, scope of market presence?

A Well, you know, to some extent people keep talking about the price that is charged by the ILEC. In a sense, that is a benchmark which is sitting in between here. I assume that is what you are thinking of.

It is a natural benchmark in the sense that, you know, if you are an IXC and you are trying to come up with a price under which the LECs are neither subsidized nor taxed -- in other words, you want a level playing field. Then the obvious price that generates a level playing field is whatever that the ILEC is charging.

Now you might think that what the ILEC is charging is way to high, okay? But you might also make a decision, which I think would be perfectly rational -- I don't know if this is what AT&T is doing -- is saying, look, on the whole, we really want to encourage CLECs, right? I mean, it is in our interest as the long distance provider to have as much competition as possible at the local exchange level.

So what we want to do is we want to

encourage that competition. So we have no interest in simply sort of, you know, taxing CLECs, trying to push CLEC rates down below the price that are charged by the ILECs with whom they compete.

Now, you know, AT&T might have had a reasonable expectation or thought that when you start getting competition at the local exchange level, the usual effect of competition is that, you know, you get some lower prices. But, you know, if that doesn't happen, I can see it as being perfectly reasonable that they would simply say, look, what we want to do is we want to keep our originating access charges down, but we don't want to place the CLEC at a competitive disadvantage vis-à-vis the ILEC.

We want to encourage their entry and expansion. So as a policy matter, they may decide simply not to -- to agree to pay a price which is at least equal to what the ILEC is charging. I think as a strategic decision, that is probably a reasonable thing.

Q Are you aware of any internal analysis that took place at AT&T as AT&T formulated their strategy with respect to MGC that would duplicate what you have just testified to as to the rationale for why they would select a particular price?

A No. It is sort of like the way I used to do my income tax. I would try to think, well, there is a logical rule, and then I would just follow it. But, no, I don't know of any specific internal analysis. It just would make sense to me that is what they were doing.

MR. LAMANCUSA: The Commission doesn't have any further questions.

JUDGE CHACHKIN: Any redirect?

MR. MERON: No, Your Honor.

JUDGE CHACHKIN: You are excused.

THE WITNESS: Thank you.

(Witness excused)